

Public Agenda Item #7a

Review and Discussion of Global Public Equity Strategies Program:

7a. Market Update and Program Overview

February 23, 2016

John Streun, MS, CFA, CPA, Director of Global Public Equity
Chris Tocci, CFA, Deputy Director of Global Public Equity
Andrew Hodson, MBA, CFA, Supervising Portfolio Manager
Tim Reynolds, MS, CFA, CAIA, Supervising Portfolio Manager
Neil Henze, CMT, Chief Equity Trader

Global Public Equity Program

Agenda



- Calendar Year 2015 Implementation Highlights
- Internal Investment Process
- Portfolio Structure and Positioning
- Developed Markets Outlook 2016
- Emerging Markets Outlook 2016
- Best Ideas Portfolios
- Trading Update
- Goals and Objectives for Fiscal Year 2016

Global Public Equity Program

Investment Objective and Strategy



- **Investment Objective** – Outperform the Global Public Equity Benchmark over rolling 5-year periods, while maintaining compliance with the Active Risk Budget.
- **Investment Strategy** – Combine lower risk internal strategies with higher risk external strategies to produce a stable excess return with a target tracking error of 150 bps and an excess return ratio of 0.25 or better.

Global Public Equity Program

Global Public Equity Team



| LEADERSHIP: John Streun, Chris Tocci, Andrew Hodson, Tim Reynolds, Neil Henze | | | | |
|---|---|---|--|---|
| Domestic Portfolio Managers | | | | |
| <u>S&P 500</u> Bob Wood MBA, CFA (25) | <u>Large Cap Active</u> Darrell Jackson (26) Kelley Hewell, CFA (23) | <u>Large Cap Growth</u> Kelley Hewell MBA, CFA (23) | <u>Mid Cap</u> Andrew Hodson MBA, CFA (14) | <u>Small Cap</u> Brent Clukey MBA, CFA (20) |
| International Portfolio Managers: | | | | |
| <u>Europe</u> Chris Tocci, CFA (24) | <u>Asia</u> Keith Lyons, MBA (12) | <u>Emerging Markets</u> Tim Reynolds MS, CFA, CAIA (23) | <u>Canada</u> Stuart Williams MBA, CFA (25) | |
| <u>Quantitative</u> Stuart Williams, MBA, CFA (25) Kelley Hewell, MBA, CFA (23) | | <u>Trading</u> Neil Henze, CMT (21) Michael Clements, CMT (18) Rob Newhall (7) | | <u>External Advisors</u> Shar Kassam, CPA, Esq. (4) Lauren Honza, MBA, CFA (22) Mike McCrary, MBA (17) |

Global Public Equity Program

Public Equity Team Structure



Industrials & Materials Team

John Streun, MS, CFA, CPA (23)

Keith Lyons, MBA (12)

Paul Knight, CFA (14)

Teofilo Bacungan, MBA, CFA (15)

Nancy McCarthy, MBA, CFA (8)

Technology & Telecom Team

Brent Clukey, MBA, CFA (20)

Chris Tocci, CFA (24)

John Taylor, MBA, CFA (10)

Darrell Jackson (26)

Flavia de la Fuente, MBA (2)

Consumer Team

Bob Wood, MBA, CFA (25)

Andrew Hodson, MBA, CFA (14)

Mark Long, MBA, CFA (19)

June Kim (9)

Naun Galvan (13)

Financial Services

Kelley Hewell, MBA, CFA (23)

Tim Reynolds, MS, CFA, CAIA (23)

Scott Hodgson, CFA (12)

Health Care Team

Stuart Williams, MBA, CFA (25)

Micheal Yuan, CFA (18)

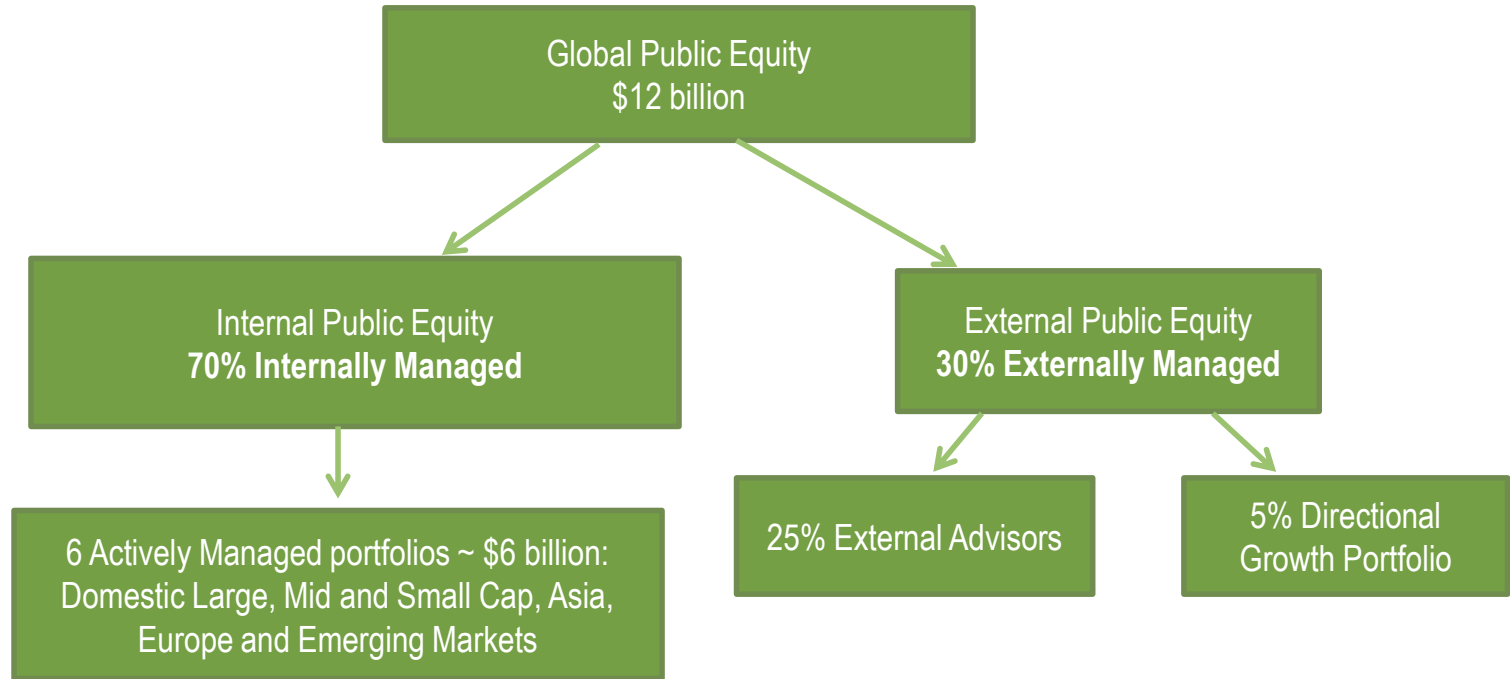
Energy

Ben Schuman, CFA (10)

Internal Investment Process

Internal Investment Process

Actively Managed Portfolios



Internal Investment Process

Searching for Alpha



- Bottom-up stock picking
- Analyst sourced ideas
 - Sell side research, industry conferences, SEC filings
- Position size
- Sector positioning

Internal Investment Process

Move to Active Share



- Active Share:
 - How different your portfolio is from your benchmark
 - Fewer holdings with larger average position size
 - Currently range from 45%-75%
 - Higher levels of excess return
 - Marginal increase in portfolio tracking errors

Internal Investment Process

Focus on Communications



- Increased focus on regularly scheduled meetings:
 - **Weekly:** Global Public Equities meeting
 - **Monthly:** Portfolio Managers meet to discuss stock moves in excess of 20% in the trailing 3 months
 - **Quarterly:** Formal Analyst/PM meeting to discuss performance attribution and current positioning

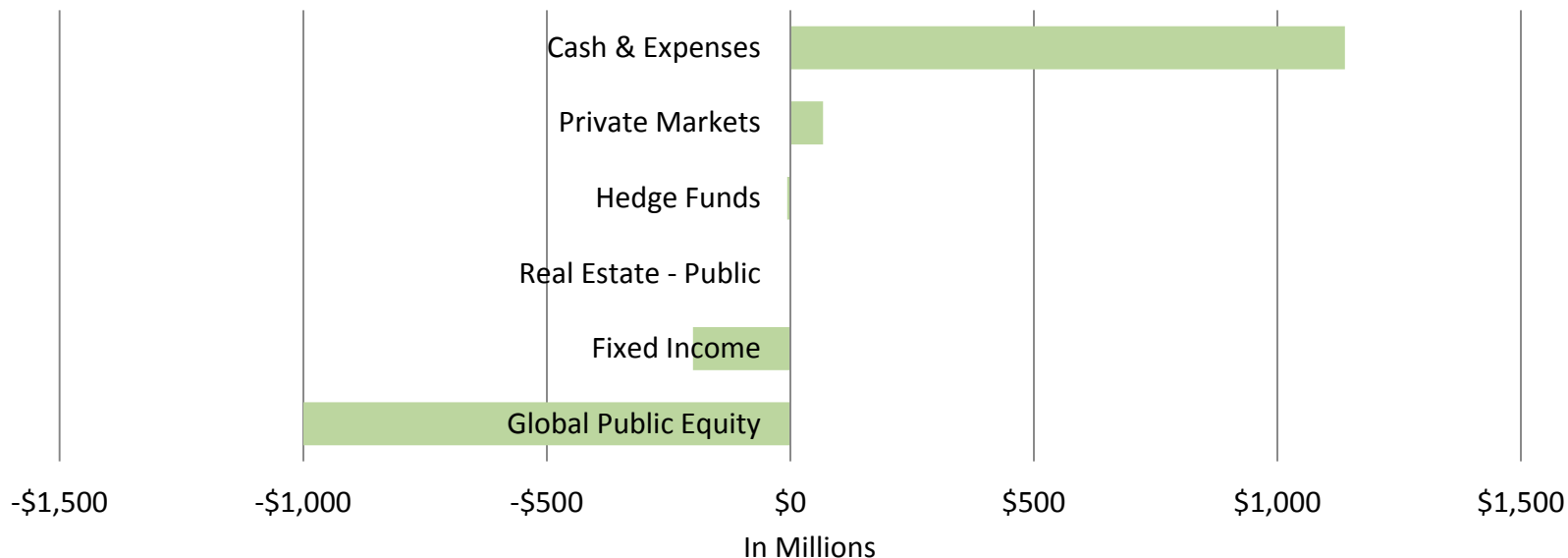
Portfolio Structure and Positioning

Portfolio Structure and Positioning

2015 Rebalancing Transfers



Rebalancing Transfers

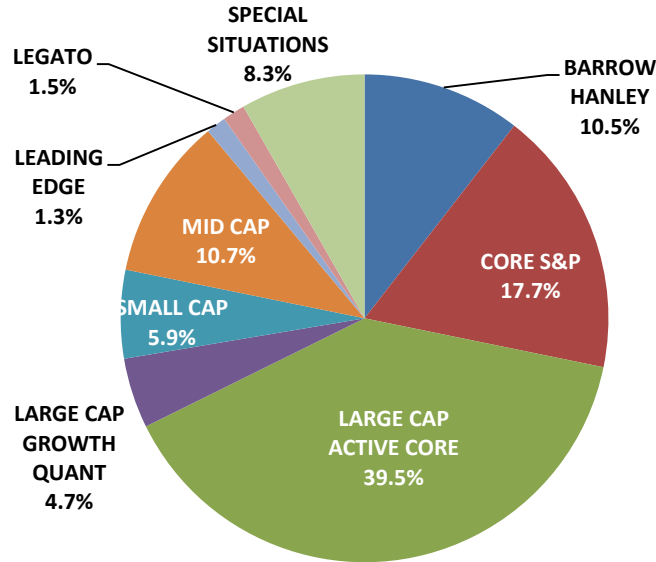


Portfolio Structure and Positioning

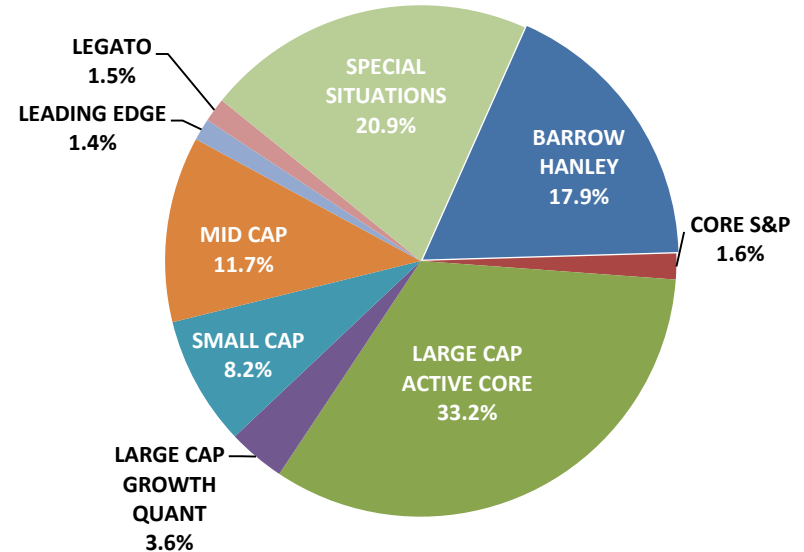
Domestic Equity



Domestic Equity - Dollar Allocation (12/31/15)



Domestic Equity - Contribution to Tracking Error, Percent (12/31/15)

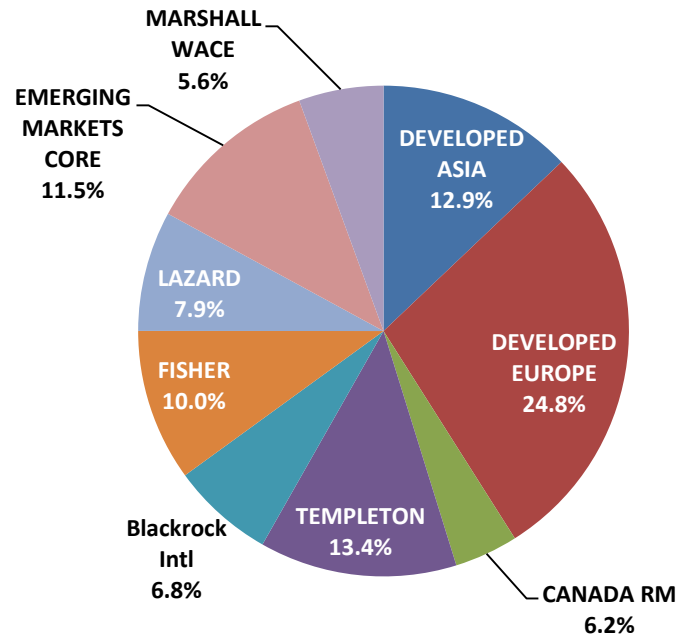


Portfolio Structure and Positioning

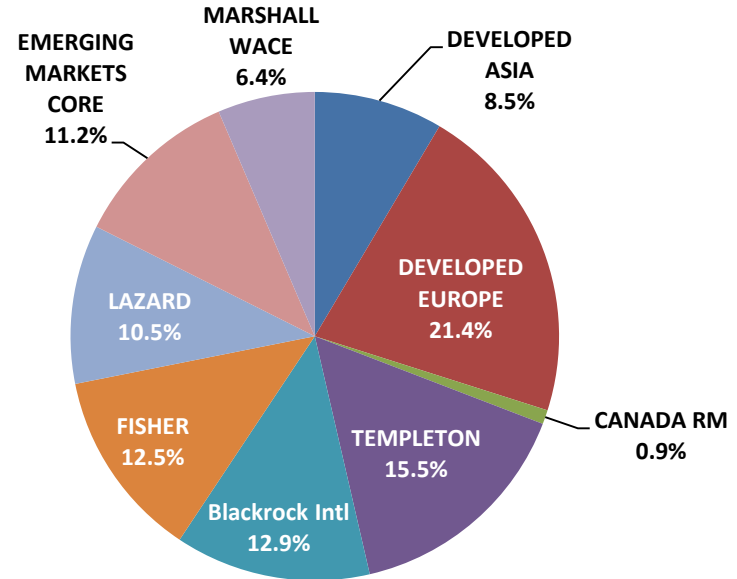
International Equity



International Equity - Dollar Allocation 12/31/15



International Equity - Contribution to Tracking Error, Percent 12/31/15



Portfolio Structure and Positioning

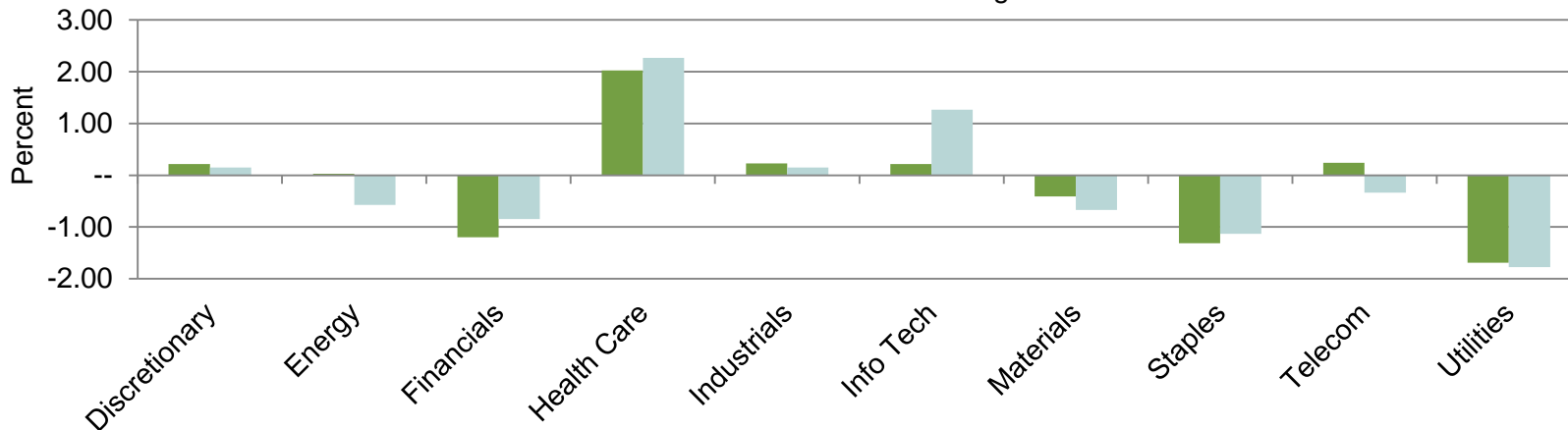
Sector Exposures



- Health Care overweight decreased slightly
- Telecom moved from underweight to slight overweight
- Energy moved to market weight while the Info Tech overweight decreased

Portfolio Position vs. ACW IMI by Sector

■ 12/31/2015 ■ One Year Ago

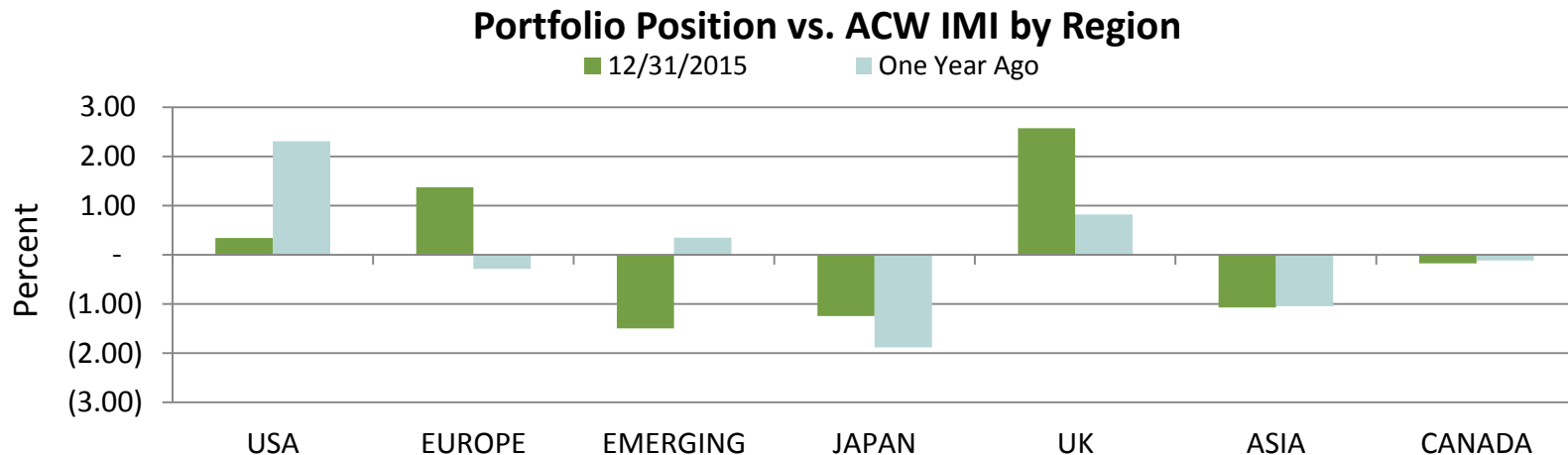


Portfolio Structure and Positioning

Regional Exposures



- Consensus underweight of Japan and underweight Asia remained in place
- Europe moved from small underweight to overweight while the UK overweight increased significantly
- Emerging Markets moved from small overweight to underweight while the US overweight declined significantly

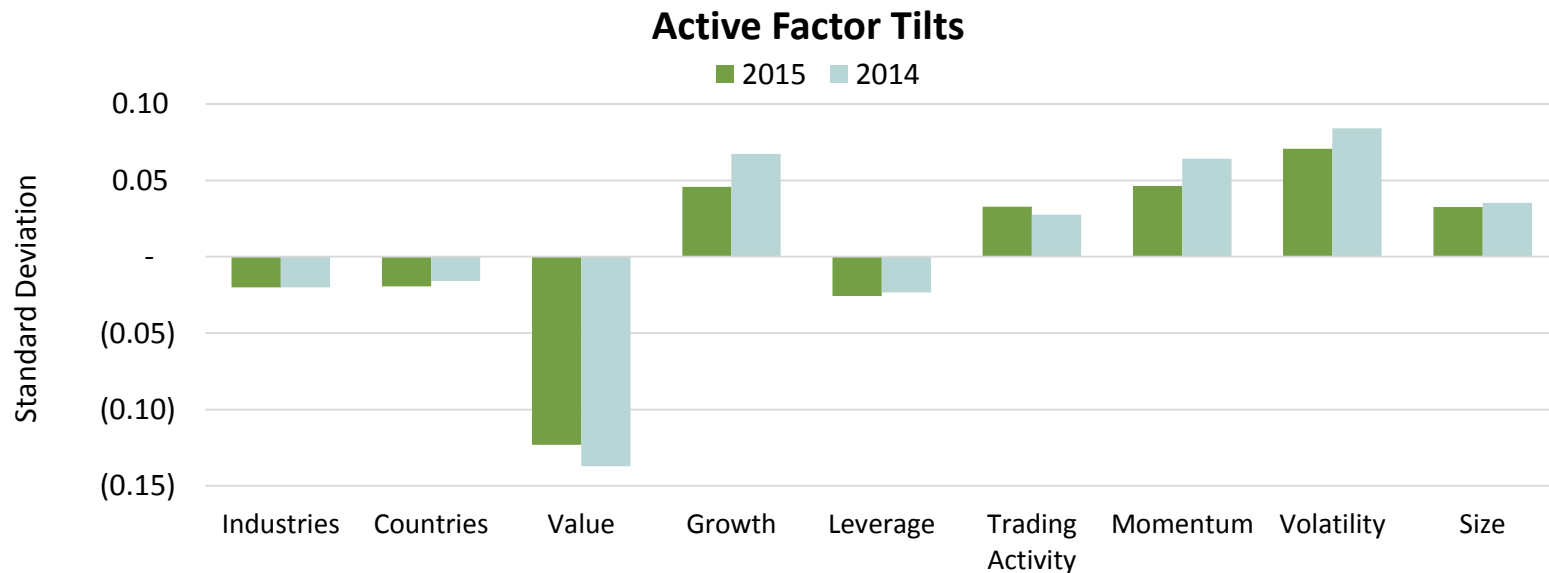


Portfolio Structure and Positioning

Factor Exposures (Portfolio Characteristics)



- Factor tilts remain small at the asset class level
- No significant changes in factor tilts between years



Developed Markets Outlook 2016

Developed Markets Outlook 2016



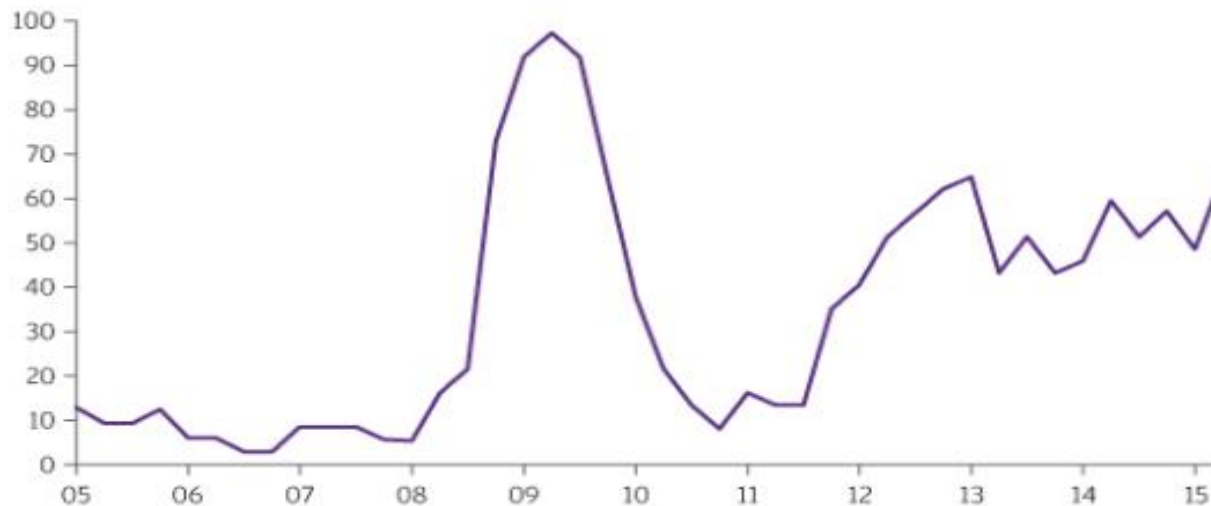
- Global Economic Outlook – Slow growth to persist
- US Outlook – Low return environment to continue
- Europe – The preferred developed market
- Japan – Improved corporate governance and easier monetary policy
- Risks to Consider – Fed Policy, geopolitics, credit

Developed Markets Outlook 2016

Global Growth to Remain Slow



Percentage of Emerging Markets with growth decelerating



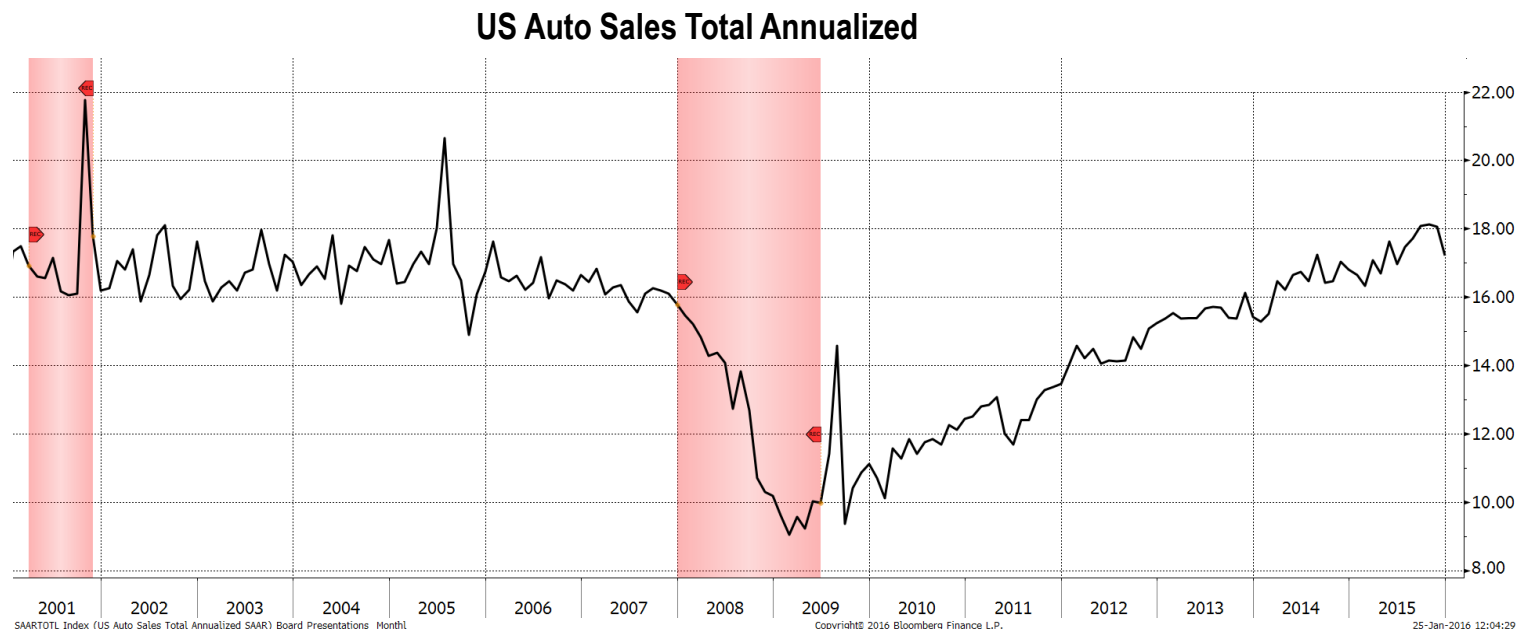
Source: JP Morgan

Developed Markets Outlook 2016

Low return environment to continue in US



Key industries in the US have fully recovered



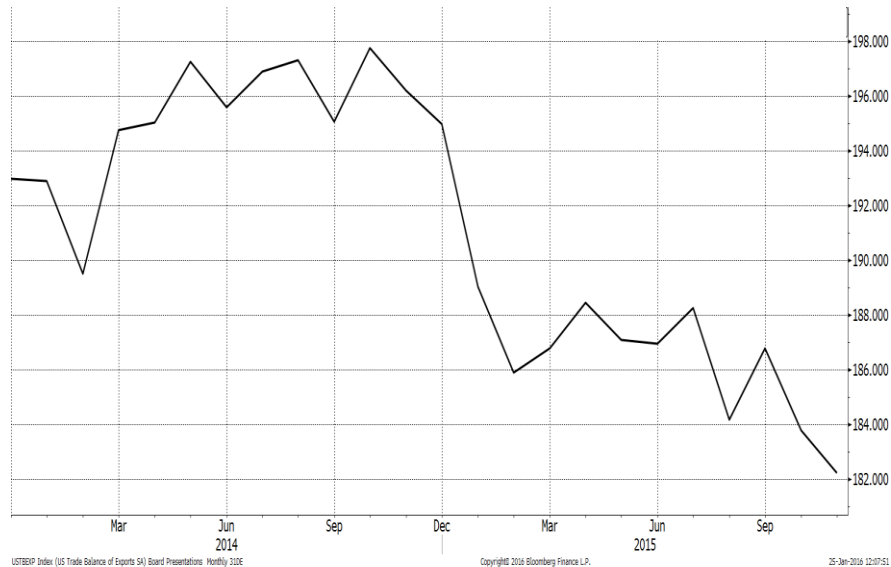
Developed Markets Outlook 2016

Low return environment to continue in US

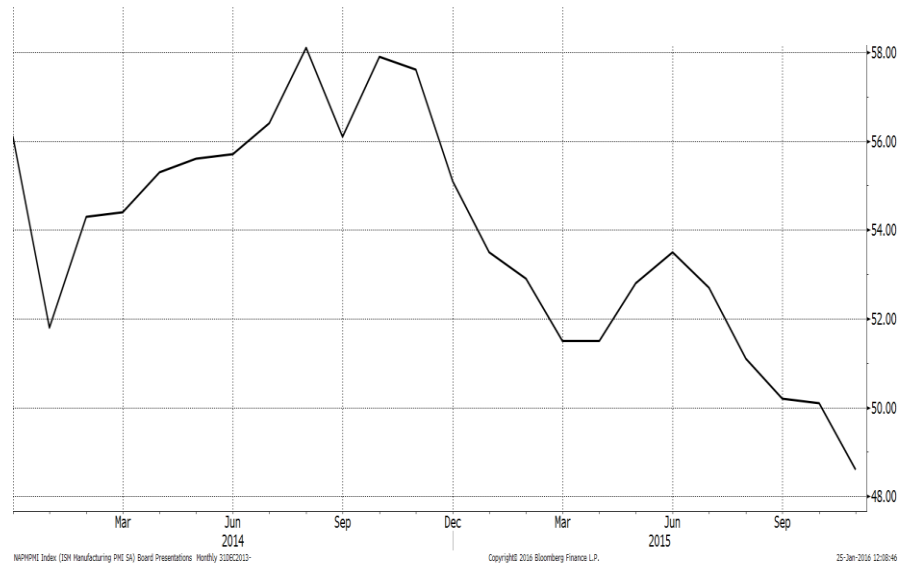


Strong U.S. dollar and crimping exports and manufacturing

US Trade Balance of Exports



ISM Manufacturing PMI SA

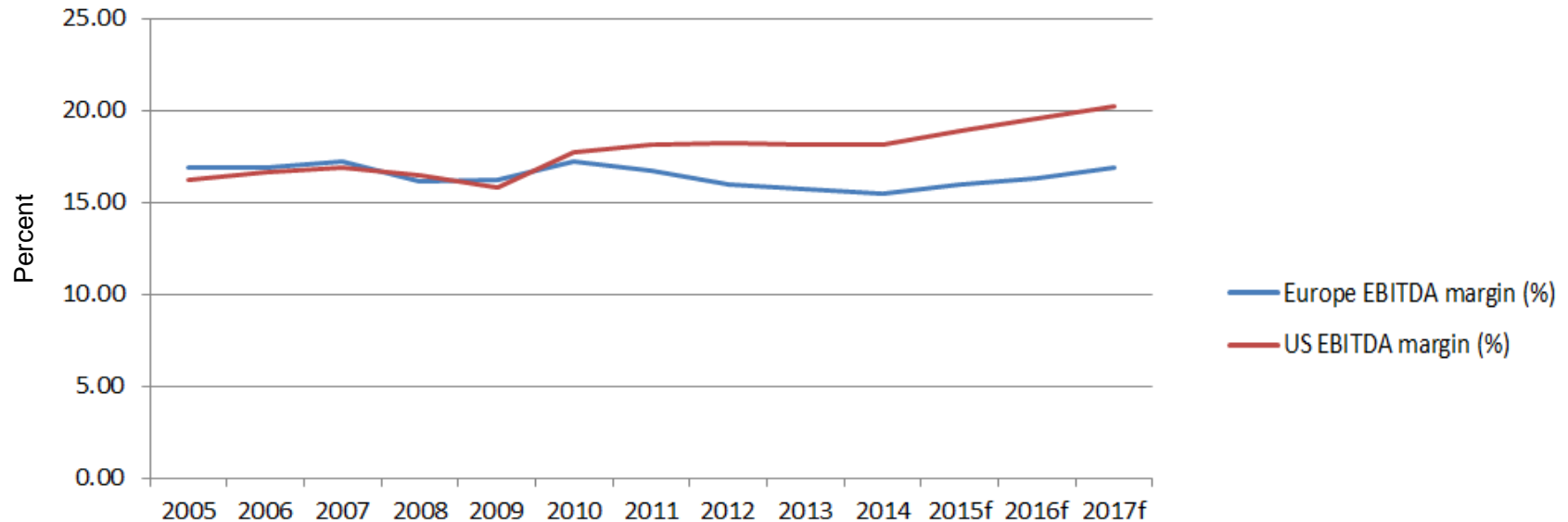


Developed Markets Outlook 2016

Europe - Preferred Developed Market



Opportunity for Europe to narrowing the operating income margin gap relative to the US

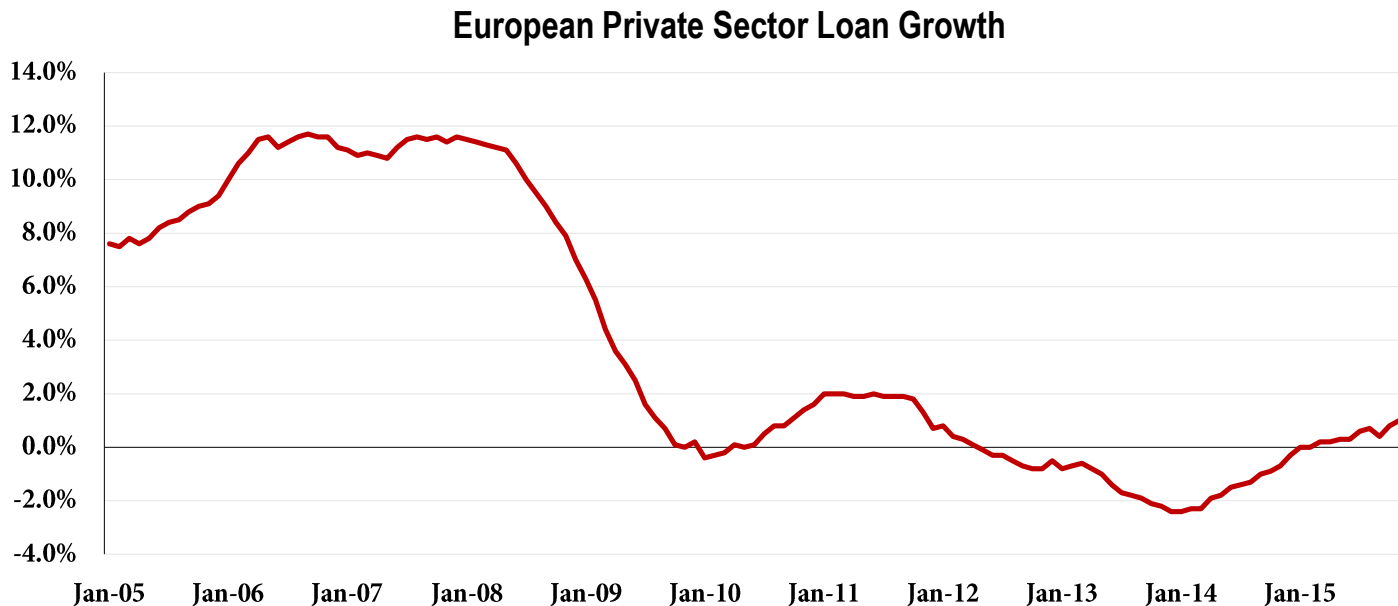


Developed Markets Outlook 2016

Europe - Preferred Developed Market



Credit conditions are improving



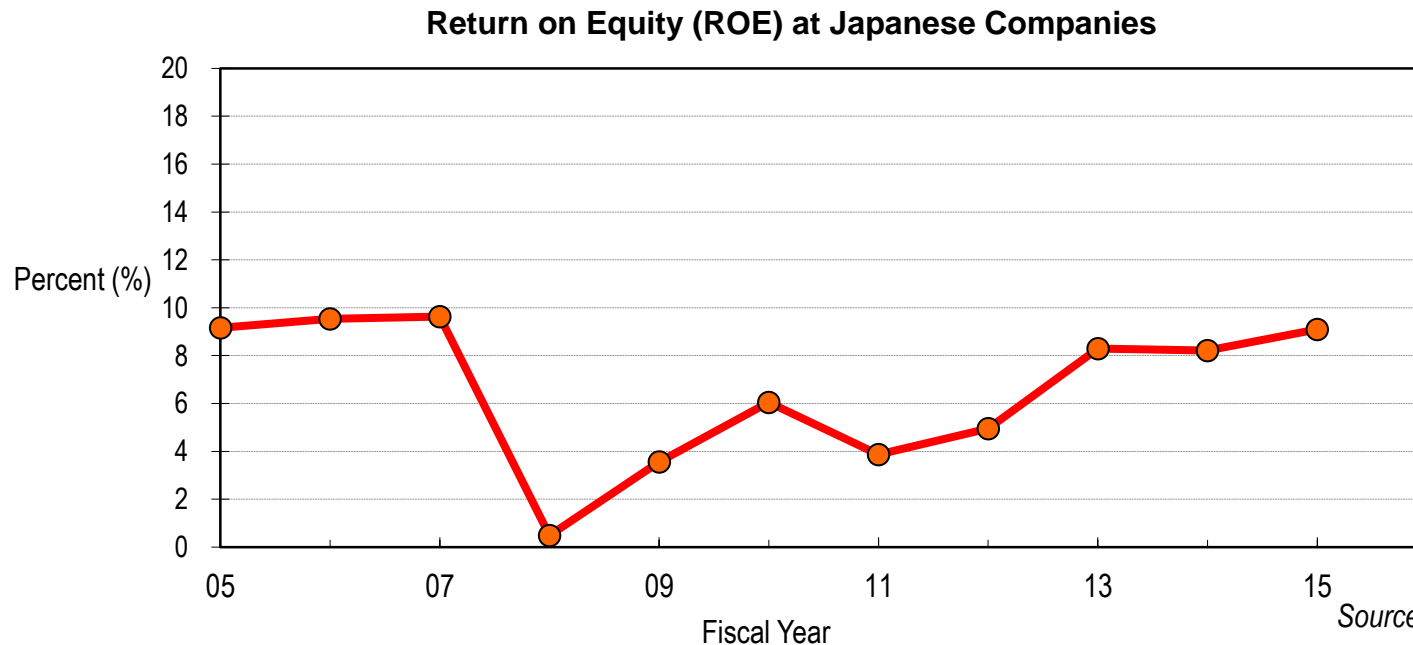
Source: Redburn Partners

Developed Markets Outlook 2016

Improved Shareholder Focus in Japan



Improvement in corporate profitability



Source: Daiwa Securities

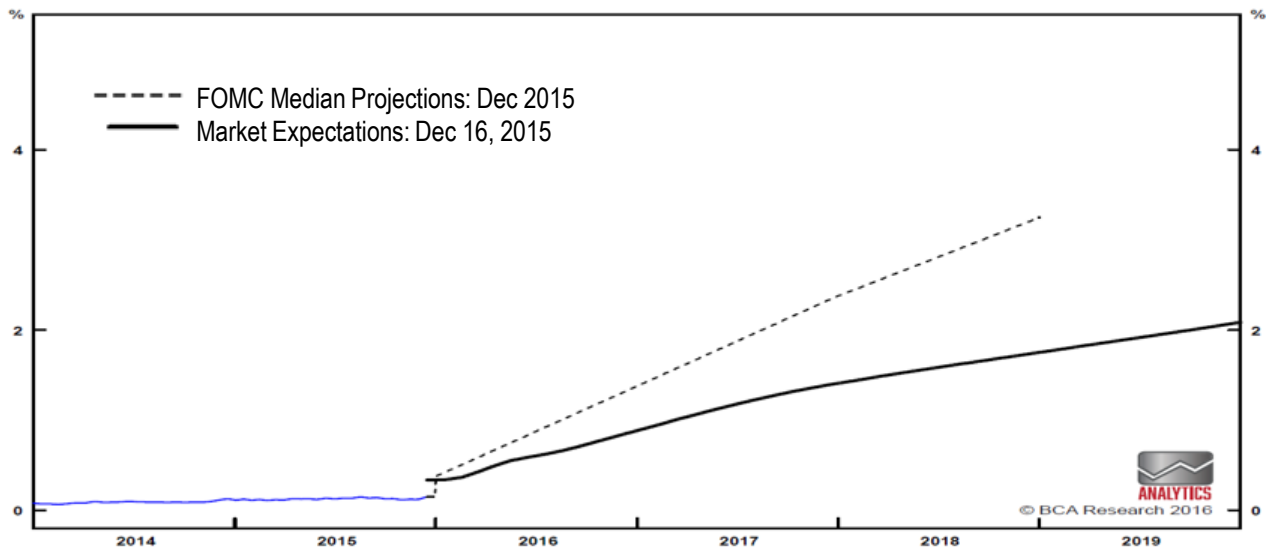
Developed Markets Outlook 2016

Risks to Consider



The Federal Reserve could raise interest rates beyond market expectations

Fed Funds Rate Trajectory

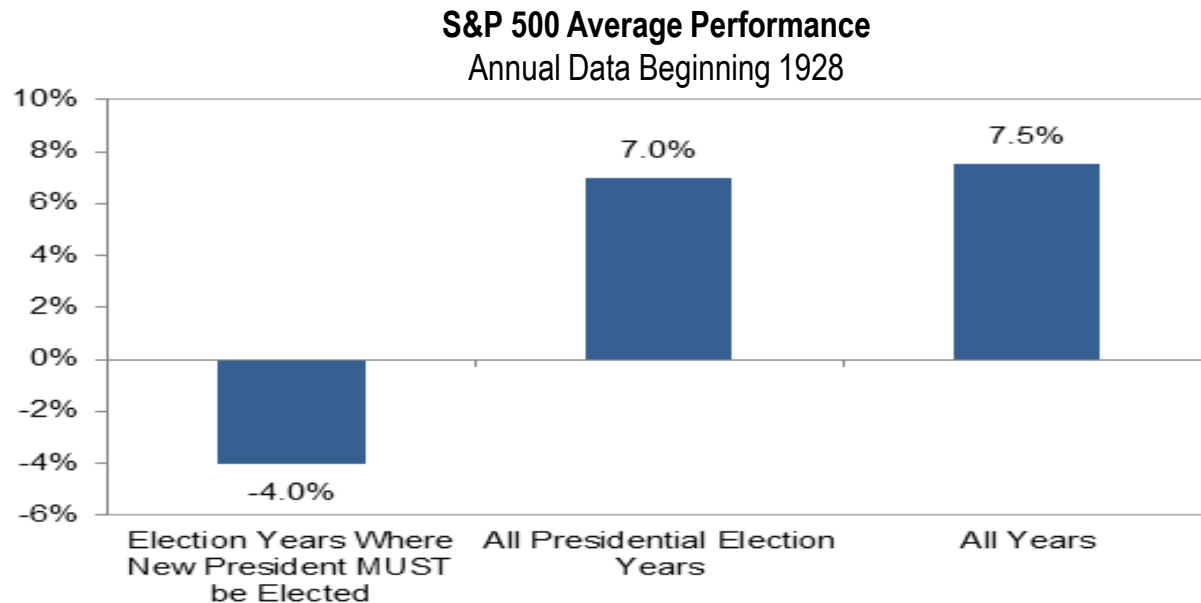


Developed Markets Outlook 2016

Risks to Consider



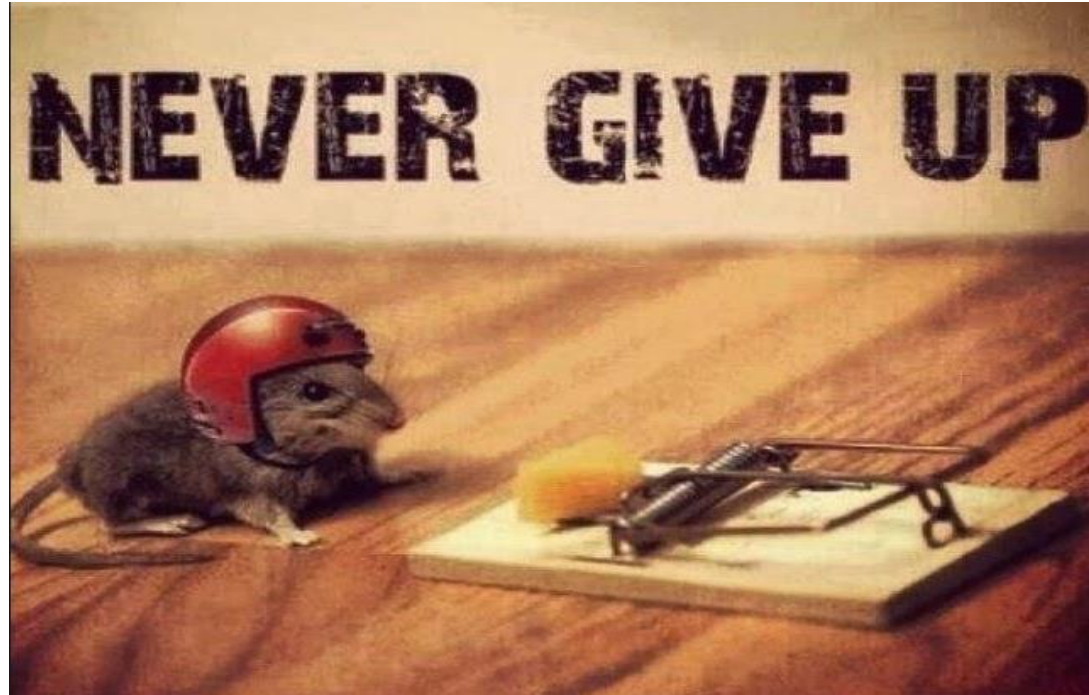
The US election cycle could result in enhanced market volatility



Emerging Market Outlook 2016

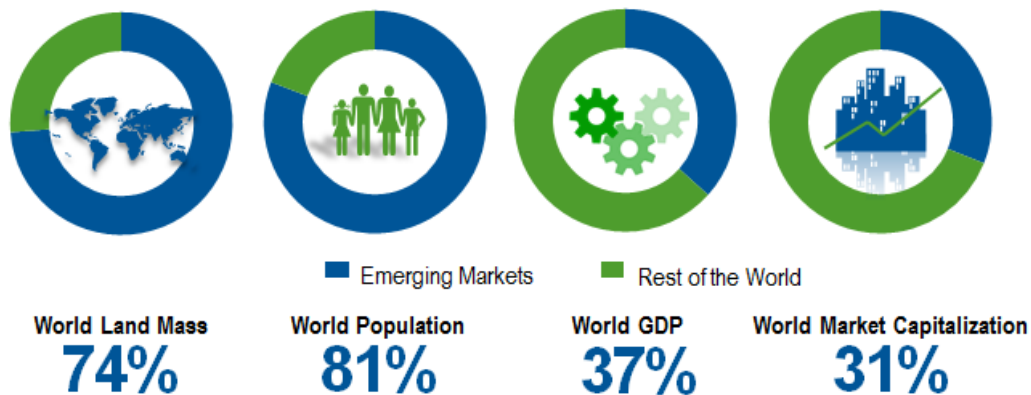
Emerging Markets Outlook 2016

Emerging Markets Investing 101



Emerging Markets Outlook 2016

Emerging Markets vs. the Rest of the World



Sources: Economist Intelligence Unit; Consensus Economics, as of September 30, 2015.



Emerging Markets Outlook 2016

Key Areas to Watch



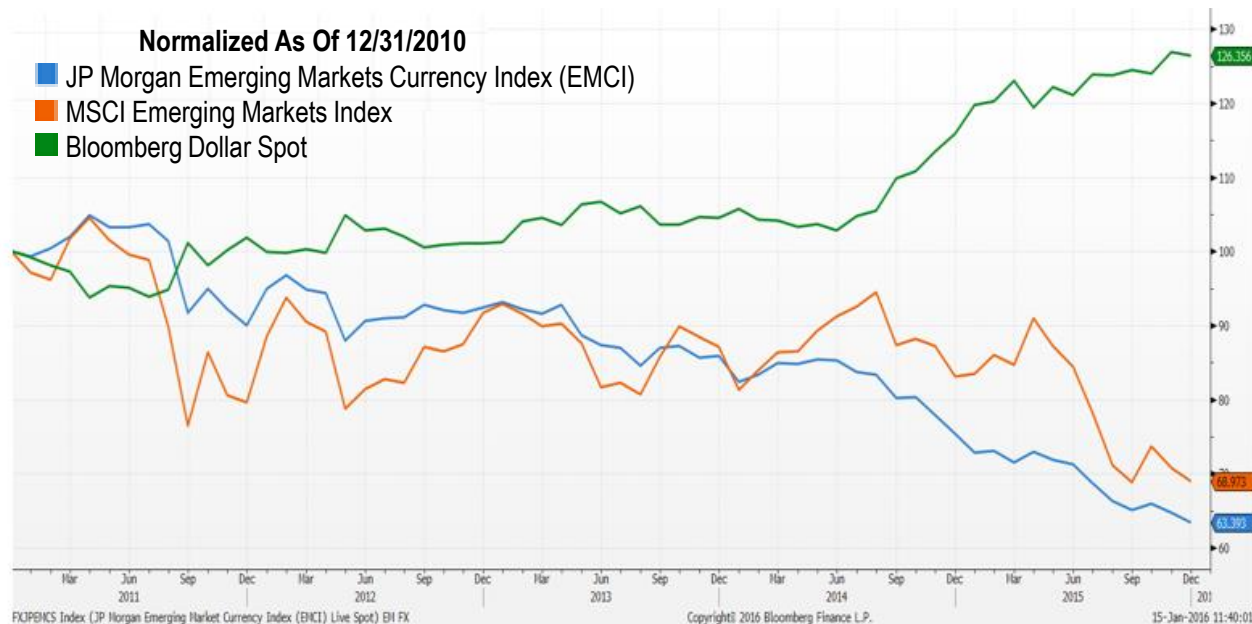
- Currency
- Earnings Revisions
- Fed Rate Hike
- Oil and Commodities
- China
- Fund Flows
- Valuation

Emerging Markets Outlook 2016

Currency



Emerging Markets currencies are steadily declining versus the US dollar

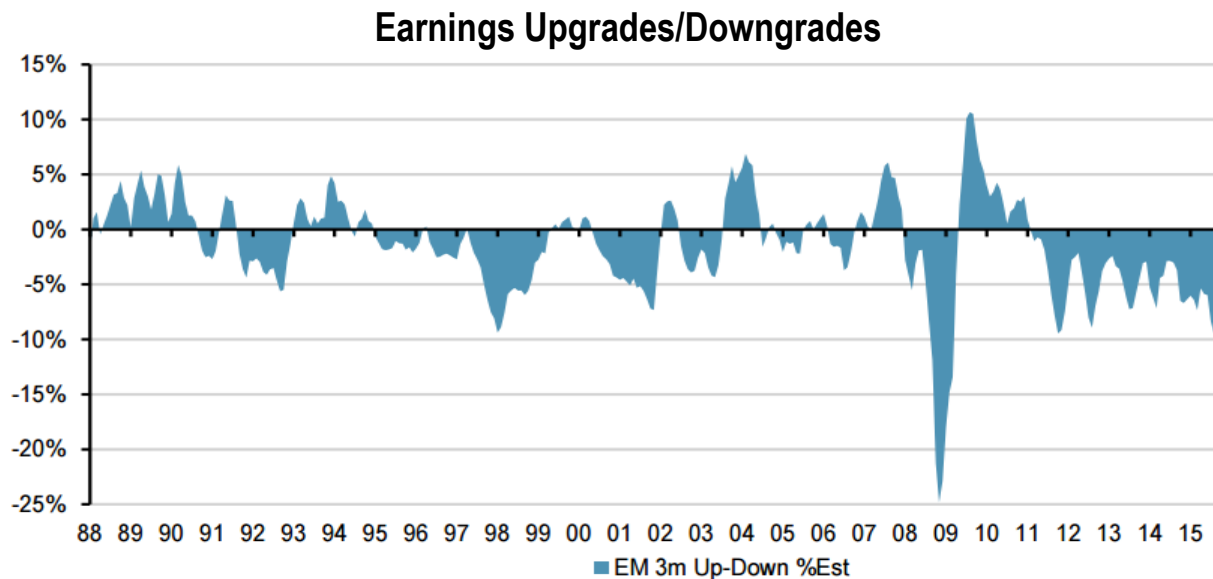


Emerging Markets Outlook 2016

Earnings Revisions



Persistently negative, unlikely to change the current economic backdrop



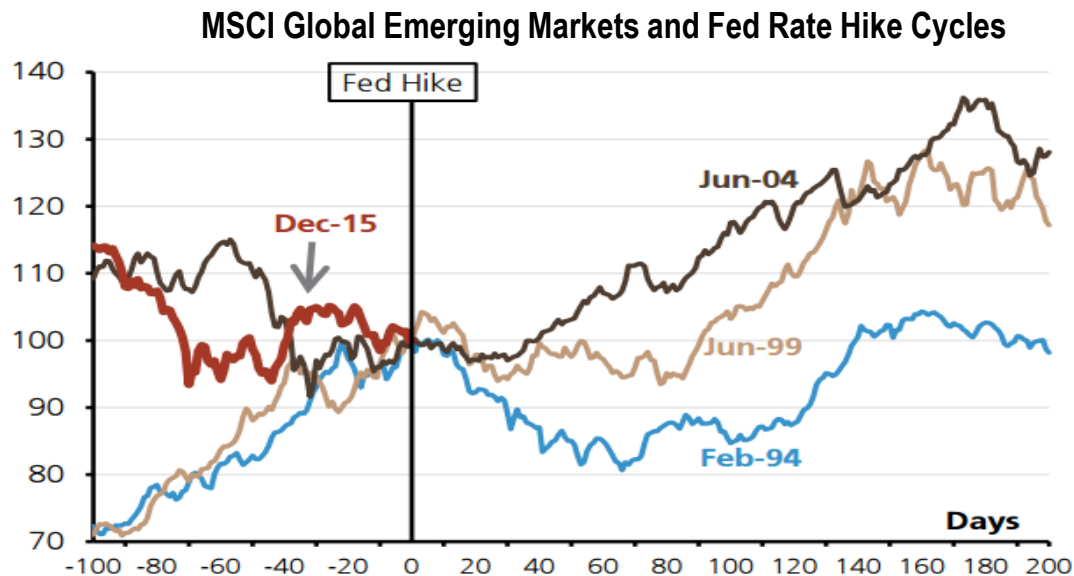
Source: Source: Datastream, MSCI, IBES, UBS GEMs Strategy. Data as of 30 November 2015

Emerging Markets Outlook 2016

Emerging Markets & The Federal Reserve



Historic rise after the first Fed Rate Hike



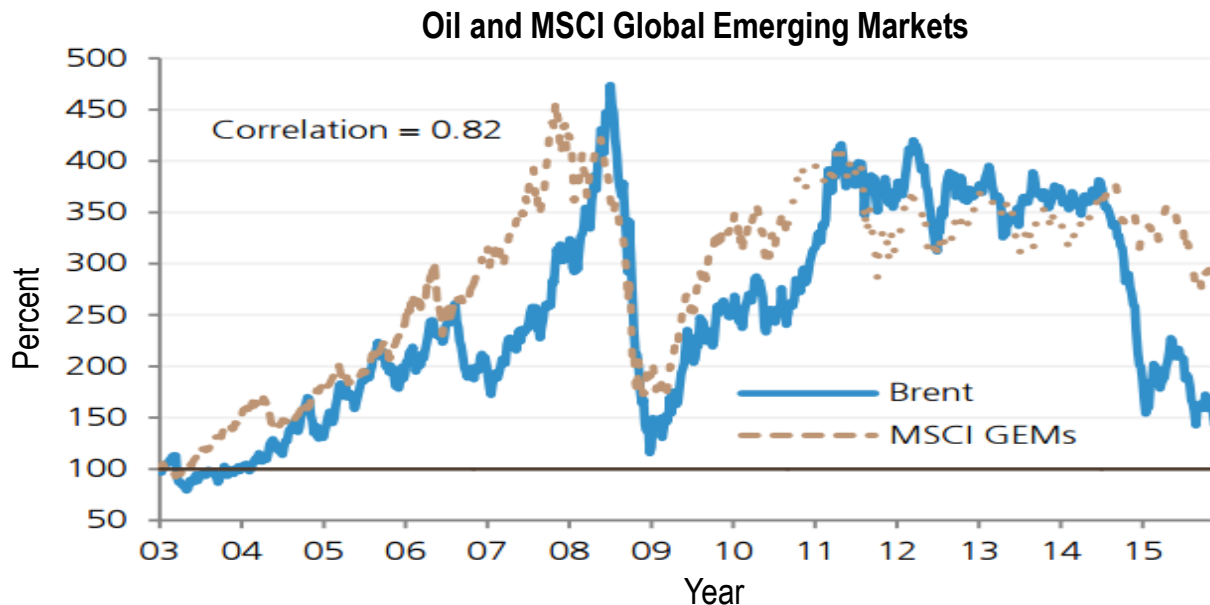
Source: MSCI, Datastream, UBS

Emerging Markets Outlook 2016

Commodities



Emerging Markets are pressured in the down cycle of oil



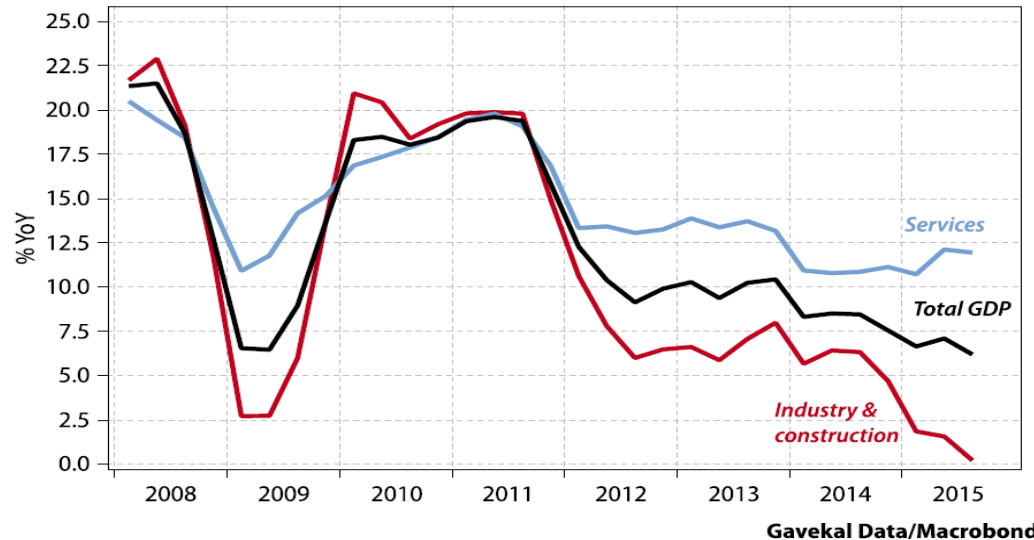
Source: MSCI, Datastream, UBS

Emerging Markets Outlook 2016

China – More than One Economy



- Services are humming away while Industry slumps
- Nominal changes in value-added by sector

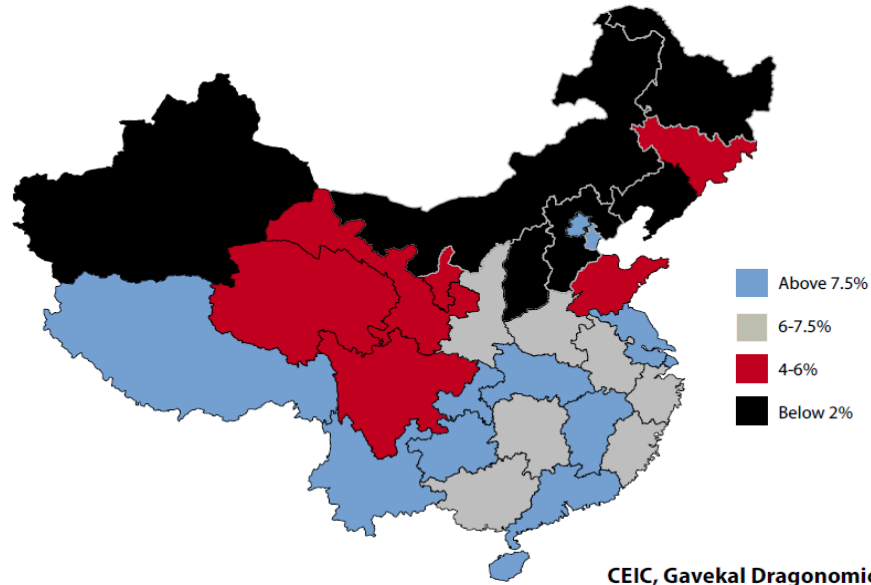


Emerging Markets Outlook 2016

China – Regional Differences



- China's northern and western provinces are the worst off
- Provincial nominal GDP growth in the first half of 2015

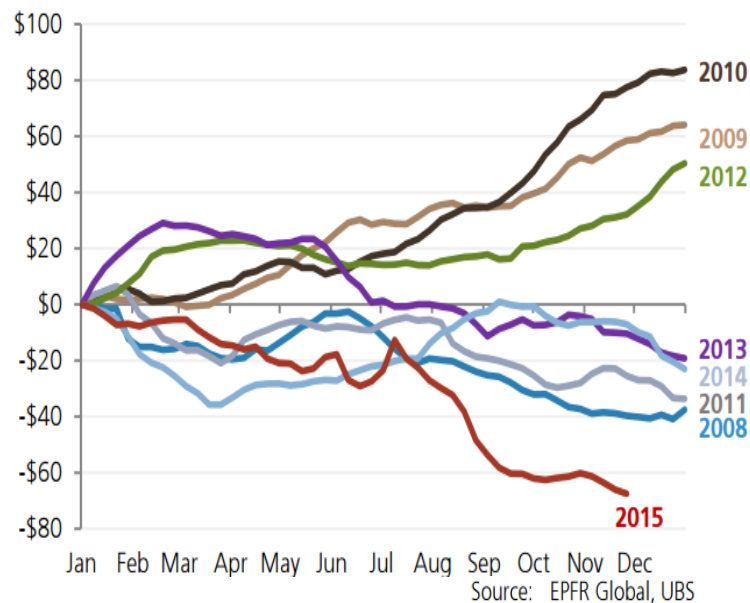


Emerging Markets Outlook 2016

Emerging Markets Fund Flows



Annual Global Emerging Markets Fund Flows (in dollars)

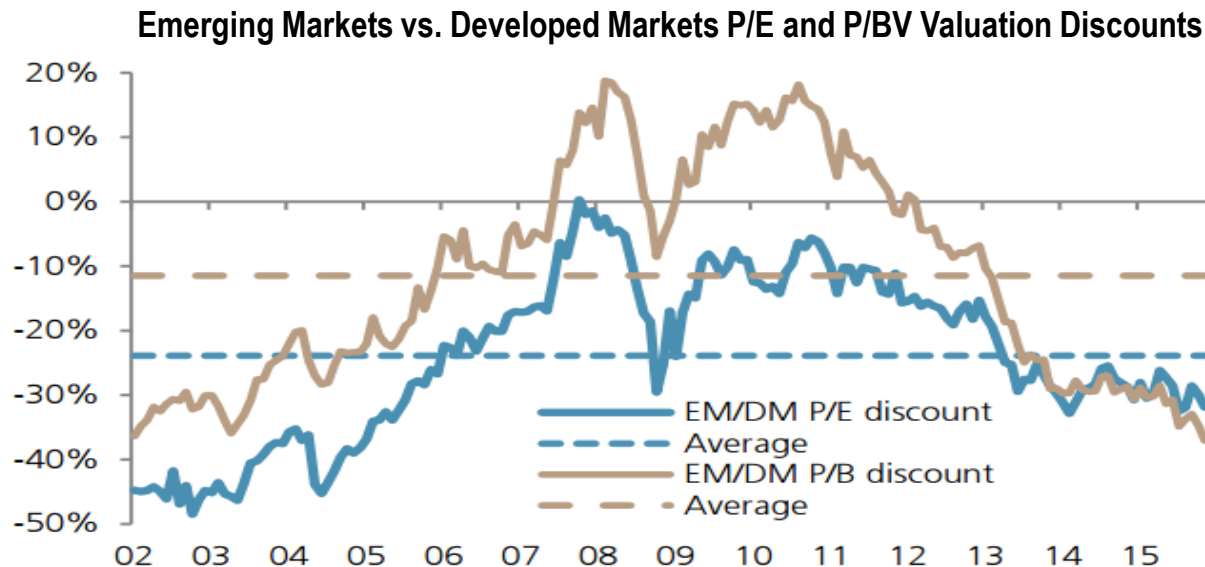


Emerging Markets Outlook 2016

Valuation



Emerging Markets are discounted on Price-to-Earning and Price-to-Book Value compared to the Developed Markets



Source: MSCI, IBES, UBS

Emerging Markets Outlook 2016

Summary



- Currency – Major drag on returns, Emerging Markets foreign exchange at record short levels
- Earning Revisions - Persistently negative, need to turn positive to garner interest
- Federal Reserve Rate Hike – Not as damaging as one might think
- China - Not carrying commodities and global GDP
- Fund flows – Can they get any worse?
- Valuations – Interesting

Best Ideas Program

Best Ideas Program

Portfolios



- Two Portfolios
 - **Spinoff portfolio:** \$300 million, inception May 1, 2014
 - **Capitol Hill portfolio:** \$200 million, inception September 1, 2014
 - Focused Value allocation was defunded
- Two formal pitches in the past year
 - Short Volatility Strategy
 - Emerging Markets with State-Owned Enterprises removed
 - Ideas informally discussed: Sector rotation, ROE improvement, share buyback, water, high value brands

Best Ideas Program

Spinoff Fund



- Performance Calendar 2015
 - Beat S&P Midcap by 101 bps
- Active share 98 versus S&P Midcap
- 7 acquisitions since inception
 - Furiex, Carefusion, Hospira, Exelis, Kraft, Alent, Baxalta
- Portfolio skewed towards newer “vintage” spinoffs

Best Ideas Program

Capitol Hill Fund



- Performance Calendar 2015
 - Beat S&P 500 by 154 bps
- Active share 83 versus S&P 500
- Outperformed in 7 out of 10 GICS sectors, indicating the lobbying effect is diffuse and not concentrated in a few sectors

Best Ideas Program

Summary



- Successful implementation of the program and two portfolios
- High levels of active share
- Minimal strain on existing resources
- Both portfolios are positive contributors to Global Public Equity versus Global Public Equity Benchmark

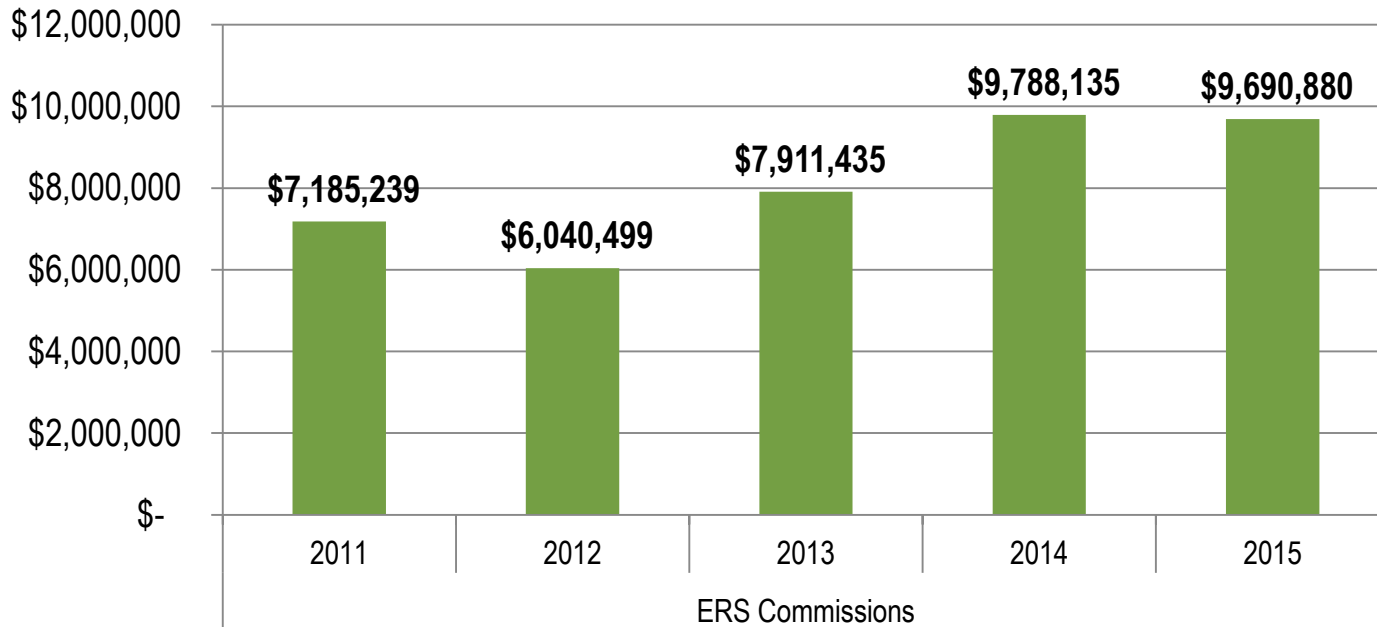
Trading Update

Trading Update

ERS Total Commissions Paid to Brokers/Dealers



Another very active year of trades

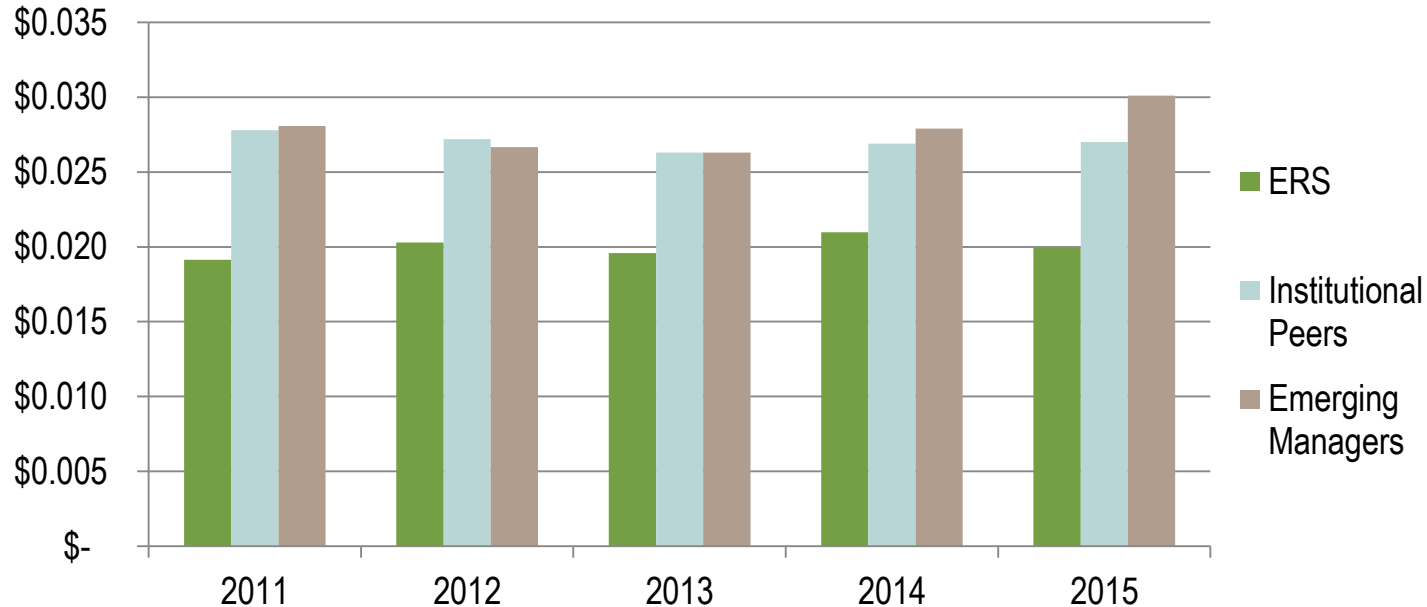


Trading Update

Commission Rate Per Share Comparison (Domestic)



Commissions continue to be lower than peers and external management

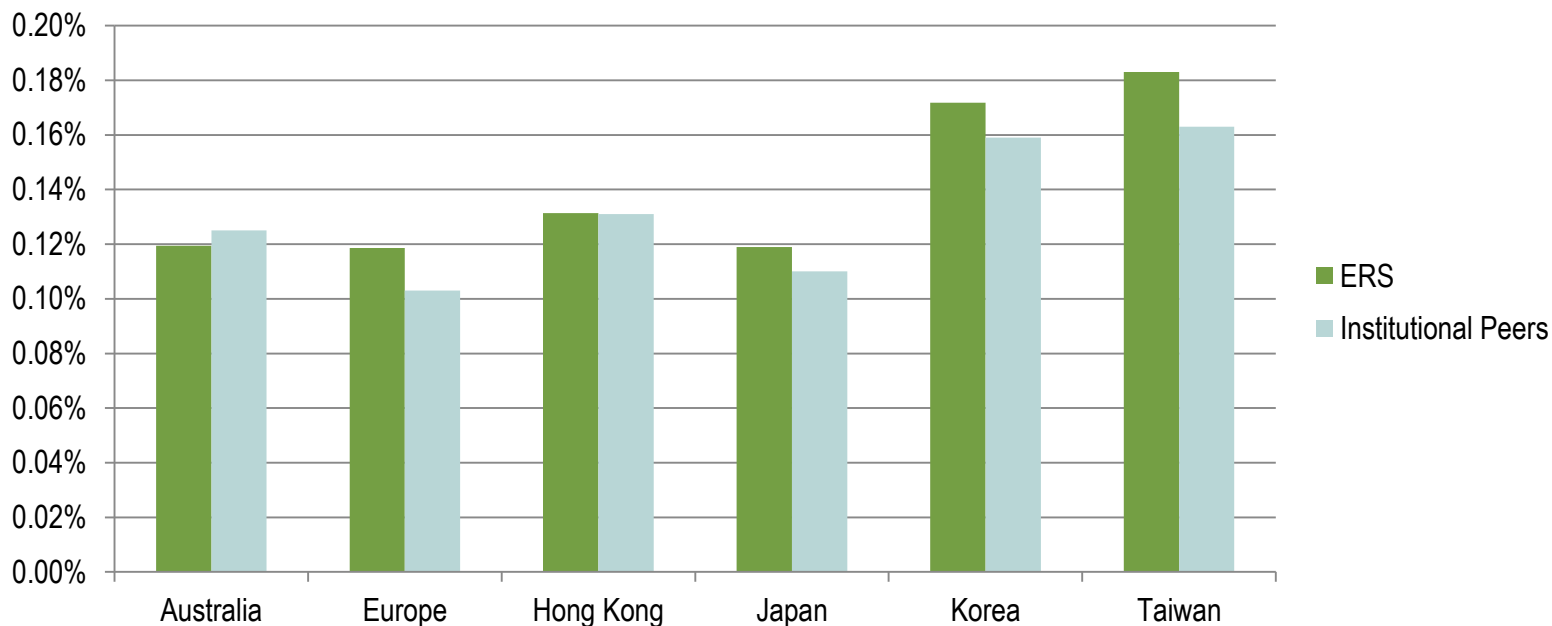


Trading Update

Commission Rate Comparison in Basis Points (International)



ERS continues to be competitive with peers

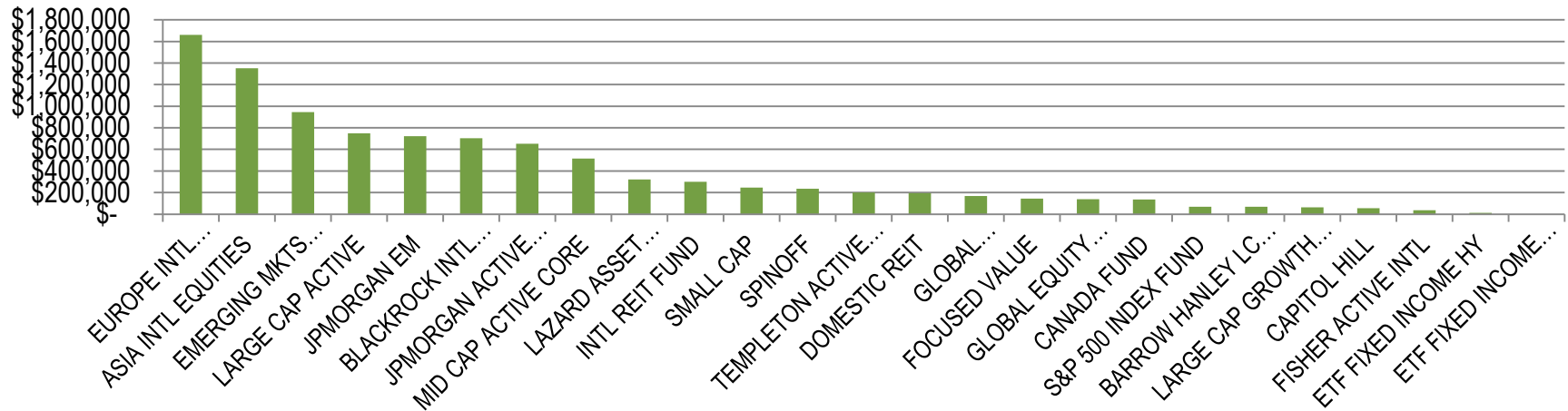


Trading Update

Commissions by Portfolio Paid to Brokers/Dealers



- Commissions for 2015 totaled \$9.6 million
- Total for Internal Portfolios was \$6.9 million (72% of the total Fund)
- Total for External Portfolios was \$2.7 million (28% of the total Fund)



Goals and Objectives for 2017

Goals and Objectives for Fiscal Year 2017



- Continue to build out options overlay program
- Improve sector allocation decision making process
- Start search for international small cap managers
- Foster new portfolios and new ideas for the Best Ideas Program
- Enhance the career path for the internal staff by developing sector PM positions

Questions?